Testimony of

John Farmakides

President/CEO of Lafayette Federal Credit Union

On behalf of

The National Association of Federal Credit Unions

"Where Are We Now? Examining the Post-Recession Small Business Lending Environment"

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Economic Growth, Tax, and Capital Access

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Introduction

Good morning, Chairman Rice, Ranking Member Chu and Members of the Subcommittee. My name is John Farmakides, and I am testifying on behalf of the National Association of Federal Credit Unions (NAFCU). Thank you for holding this important hearing today. I appreciate the opportunity to share our views on small business lending from a lender's perspective.

Currently, I serve as the President and CEO of Lafayette Federal Credit Union headquartered in Kensington, Maryland, a position I have held since 2007. Lafayette has a rich history of serving the greater Washington, D.C. area and was established in 1935 offering small personal loans to members. Today Lafayette has approximately 14,000 members, over 65 employees and more than $366 million in assets. We provide a full range of financial services including member business loans through several branches in Maryland, Virginia, and the District of Columbia. I have been an active member of the Lafayette community for over 20 years, serving on the supervisory committee as chairman and as treasurer of the board before being named President and CEO in 2007. I also have experience in investment banking and commercial real estate.

In addition to my responsibilities at Lafayette, I also currently sit on the Regulatory Committee at the National Association of Federal Credit Unions (NAFCU). As you may know, NAFCU is the only national organization that exclusively represents the interests of the nation's federally chartered credit unions. NAFCU member credit unions collectively account for approximately 68 percent of the assets of federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this important and timely discussion.

Background on Credit Unions

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche credit unions fill today for nearly 97 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 § USC 1752(1)). While over 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

The nation's approximately 7,000 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided, but also—more importantly—to quality and cost of those services. Credit unions are second-to-none in providing their members with quality personal financial services at the lowest possible cost.

Impediments to Credit Union Business Lending

When Congress passed the *Credit Union Membership Access Act* (CUMAA) (P.L.105-219) in 1998, it put in place restrictions on the ability of credit unions to offer member business loans (MBL). Credit unions had existed for nearly 90 years without these restrictions. Congress codified the definition of an MBL and limited a credit union's member business lending to the lesser of either 1.75 times the net worth of a well-capitalized credit union or 12.25 percent of total assets.

CUMAA also established, by definition, that business loans above $50,000 count toward the cap. This number was not indexed and has not been adjusted for inflation in the 15 years since enactment, eroding the *de minimis* level. Where many vehicle loans or small lines of credit may have been initially exempt from the cap in 1998, many of these types of loans that meet the needs of small business today are now impacted by the cap due to this erosion. To put this in perspective relative to inflation, what cost $50,000 in 1998 costs $71,639 today, using consumer price index data. That is a change that is completely ignored by current law and greatly hamstrings a credit union's ability to meet its members' needs.

The mere existence of an member business lending cap acts as a deterrent for credit unions to start an MBL portfolio knowing that as their program thrives they will face this arbitrary threshold and may have to turn members away. Furthermore, it should be noted that those credit unions that do have an MBL program are disincentivized from offering working capital lines of credit given that, regardless of whether or not the line of credit is actually drawn, it still counts against the cap. As members of the subcommittee are aware, working capital lines of credit are critical to small companies as a way to meet day-to-day cash shortfalls and manage the needs of a growing business.

It should be noted that the government guaranteed portions of Small Business Administration (SBA) loans do not count toward the member business lending cap, but the non-guaranteed portions do. This could ultimately lead to a situation where a credit union may be an excellent, or even preferred, SBA lender and ultimately have to scale back participation in SBA programs as they approach the arbitrary cap. This would likely hit SBA Express or Patriot Express loans first, as those have lower guarantees and thus may have a bigger impact on money available below the cap. As you know, Patriot Express loans help give our nation's veterans more opportunities after they return from serving our country. The member business lending cap can deter the availability of those opportunities.

Also, pursuant to section 203 of CUMAA, Congress mandated that the Treasury Department study the issue of credit unions and member business lending. In January 2001, the Treasury Department released the study, "Credit Union Member Business Lending" and found the following: "…credit union's business lending currently has no effect on the viability and profitability of other insured depository institutions." (p. 41). Additionally, when examining the issue of whether modifying the arbitrary cap would help increase loans to businesses, the study found that "…relaxation of membership restrictions in the Act should serve to further increase member business lending…" (p. 41).

The 2001 Treasury study found that credit unions do not pose a threat to the viability and profitability of banks, but that in certain cases, they could be an important source of competition for banks. It is important to note that credit unions have a nominal market share of the total commercial lending universe (approximately 6% of all small business loans from insured depository institutions), and are not a threat to other lenders (who control nearly 94% of all small business loans from insured depository institutions) in this environment.

A 2011 study commissioned by the SBA's Office of Advocacy affirms these findings. (James A. Wilcox, *The Increasing Importance of Credit Unions in Small Business Lending*, Small Business Research Summary, SBA Office of Advocacy, No. 387 (Sept. 2011)). The SBA study also indicates, importantly, that credit union business lending has increased in terms of the percentage of their assets both before and during the 2007-2010 financial crisis while banks' has decreased. This demonstrates not only the need for lifting the cap in order to meet credit union members' demand, but also that credit unions continue to meet the capital needs of their business members even during the most difficult of times. One of the findings of the study was that bank business lending was largely unaffected by changes in credit unions' business lending. Additional analysis in the study also found that credit unions' business lending can actually help offset declines in bank business lending during a recession.

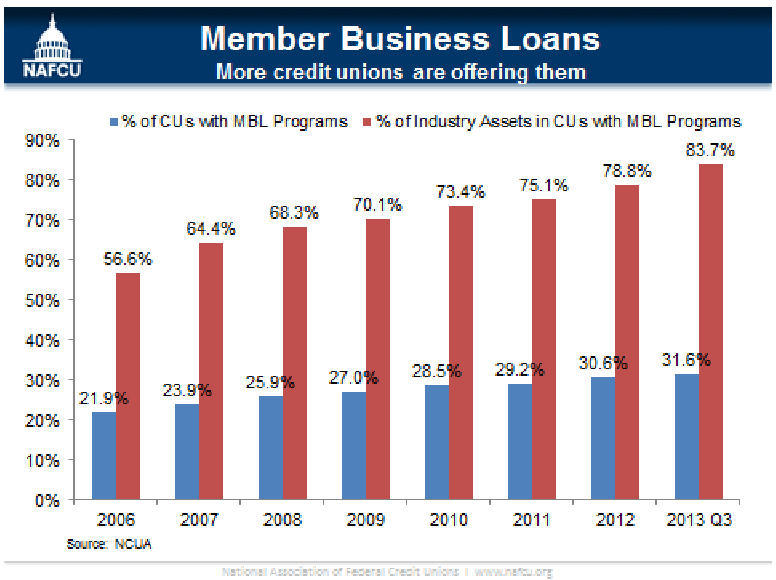
Bipartisan legislation to address this issue, in the form of H.R. 688, the *Credit Union Small Business Jobs Creation Act*, is pending before the Financial Services Committee. Introduced by Reps. Ed Royce (R-CA) and Carolyn McCarthy (D-NY) this legislation would raise the current 12.25% limit to 27.5% for credit unions that meet certain criteria. One alternative to the approach in H.R. 688 would be to raise the outdated "definition" of an MBL from last century's $50,000 to a new 21st century standard of $250,000, with an indexing of inflation to prevent future erosion. Furthermore, MBLs made to non-profit religious organizations, made for certain residential mortgages (such as non-owner occupied 1-4 family residential mortgages), made to business in "underserved areas" or made to small businesses with fewer than 20 employees should be given special exemptions from the cap.

The ever-growing regulatory burden being placed on credit unions also serves to hamper the ability of credit unions to make business loans, as capital is diverted from lending to compliance costs. In early February of this year, NAFCU was the first credit union trade association to formally call on the new Congress to adopt a comprehensive set of ideas generated by credit unions that would lead to meaningful and lasting regulatory relief for our industry (A copy of the letter is attached to my testimony). Based on feedback from our membership and the strong expectation for future growth, regulatory relief on the member business lending front is a key component of NAFCU's five-point plan. Another important aspect of this proposal is capital reforms for credit unions, such as establishing a risk-based capital system and allowing credit unions to seek access to supplemental capital. Providing regulatory relief on these fronts will help make sure credit unions continue to have the capital available to lend our nation's small businesses.

The Member Business Lending Environment Post Financial Crisis

A November 2013, survey of NAFCU members found that member business lending is expected to grow over the next twelve months. On a scale that goes from -100 to +100 (where zero indicates flat growth), the August-October median growth expectation for credit unions regardless of geographic location was 35.6. Furthermore, asset quality continues to improve for member business loans at credit unions, with charge-offs down to only 0.38%.

As illustrated in the graph below, the percentage of credit unions with member business lending programs has been rising steadily since the financial crisis.



While other lenders pulled back on business lending during the economic downturn, credit unions continued to lend to their small business members. Furthermore, as those small business members lost lines of credit from other lenders, they turned to credit unions to help meet their needs, leading to an increased demand for credit union business loans.

Member Business Lending at Lafayette Federal Credit Union

Lafayette has seen a need arise from our small business members to get lines of credit that they have lost from other lenders. As a result, we have expanded our focus into this area in 2013. For example, we gave a $125,000 line of credit to a local bike rental and touring company to help with their cash flow due to the cyclical nature of their business. This loan helps them maintain their 8-10 full-time employees in the off-season (which then grows to 50-60 in season).

While our credit union proudly meets our local communities' lending needs, the arbitrary member business lending cap is now having a direct negative impact on how well we can serve our members. Many small businesses come to us looking for large lines of credit to help them meet cyclical challenges. However, any line of credit above $50,000 counts toward our member business lending cap, even if the funds are not extended. This fact hampers our ability to meet the needs of many of our small business members.

So far in 2013, we have done ten commercial and industrial member business loans averaging out at about $61,000 each, evidence that most are considered small but are still "large" enough to count against the arbitrary cap. Many of our loans in this area tend to be lines of credit advances aimed at financing for cash flow purposes or startup costs. We have also been able to assist very small traditional companies like a specialty bakery with a single employee-owner and a trucking delivery service. At the same time, we have made loans to several consulting firms related to government contracting as well as an innovative solar energy appliance company.

It is worth noting that Lafayette takes our MBL program very seriously and we have recruited the appropriate personnel with the appropriate experience to ensure it is sound and successful. While others in the financial services industry may claim credit unions aren't sophisticated enough or able to attract the correct personnel to make member business loans, this is simply a misnomer.

SBA Lending at Lafayette Federal Credit Union

Small businesses are the backbone of our economy and an important source of jobs for Americans. The Small Business Administration's loan programs serve as an important resource that helps credit unions provide small businesses with the vital capital necessary for growth and job creation. However, utilizing any SBA loan guaranty program requires meeting stringent government regulations. While we are an approved SBA 7(a) lender, we currently have just one SBA 504 loan outstanding, and one USDA Business & Industry loan outstanding.

Determining overall applicant eligibility to participate in an SBA program is nearly as important as determining the applicant's creditworthiness. Failing to meet certain eligibility criteria may preclude the applicant from participating in an SBA guaranteed loan program. Eligibility criteria includes among other things: size restrictions, type of business, use of proceeds, credit standards, and meeting a 'credit-elsewhere' test.

If Congress and the SBA were to make it easier for credit unions to participate in these programs, small businesses throughout the nation will have greater access to capital at a time when it is needed most. NAFCU would support SBA loans being permanently exempted from counting against a credit union's MBL cap in full. These suggested changes, which allow credit unions to do more to help our nation's small businesses, are an important step to help our nation recover from the current economic downturn.

Conclusion

Small businesses are the driving force of our economy and the key to its success. The ability for them to borrow and have improved access to capital is vital for job creation. Credit unions play an important role in helping our nation's small businesses get the access to funds that they need. We want to do more, however, we are hamstrung by an outdated artificial member business lending cap that ultimately hurts small businesses. We urge the subcommittee to support legislation to make it easier for credit unions to meet the business lending needs of their members and to expand participation in SBA programs.

We thank you for your time and the opportunity to testify before you here today on this important issue to credit unions and our nation's economy. I would welcome any questions that you may have.

Attachment: NAFCU letter to Chairman Johnson, Chairman Hensarling, Ranking Member Crapo and Ranking Member Waters calling on Congress to provide credit union regulatory relief; February 12, 2013.